Approved February 3, 1983
Date

MINUTES OF THE Senate COMMITTEE ON Governmental Organization.

The meeting was called to order by Senator Vidricksen at
Chairperson

1:35 xxx/p.m. on February 2, 1983 in room 531-N of the Capitol.

All members were present except:

Committee staff present:

Norm Furse - Revisor
Julian Efird - Legislative Research

Conferees appearing before the committee:

Leo Hafner - Legislative Post Audit
Mark Beshears - Department of Revenue

Legislative Post Audit distributed copies of their findings on the audit of the Division of Taxation (Exhibit A) and addressed the committee on this report. Three major points were discussed, those being: identifying and registering businesses, managing tax remittance cycles, and following up on delinquent accounts. Brief comments were made by members of the committee.

Attention was then turned to the report from the Department of Revenue. (Exhibit B) The Department maintained that a number of recommendations and conclusions contained in the Post Audit report were based upon erroneous or misleading presentation of facts and gave examples of data.

Several questions were raised by committee members but discussion was cut short due to the time factor.

Senator Roitz made the motion to approve the minutes of the previous meeting. This was seconded by Senator Hein and motion carried.

The meeting was adjourned at 2:30 p.m. by the Chairman.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

GUEST LIST

COMMITTEE: Senate Governmental Organization DATE: Feb. 2, 1983

NAME	ADDRESS	COMPANY/ORGANIZATION
Glenn Deck	Topeka	Legis. Post Audit
Leo Hafner	Topeka	L P A
Vicky S. West	Topeka	LPA
MARK Beshears	"	Dep't of Revenue
ALAN ANDERSON	"	" " "
BILL EDDS	"	"

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present the findings of our performance audit of the Division of Taxation. The audit was one of a series of audits conducted of various divisions within the Department of Revenue in conjunction with the Kansas Sunset Law.

The audit focused on the administration and enforcement of sales and withholding taxes which accounted for more than half of the approximately $1.3 billion dollars in revenues administered by the Division of Taxation during fiscal year 1981. It is important to note at the outset that these taxes are not paid out of business profits. Instead, they are paid by consumers and wage earners across the State. Failure to remit these taxes to the State represents an illegal diversion of the taxes which have already been paid by consumers and wage earners.

The audit addressed three components of Sales and Withholding tax enforcement

--Identifying and Registering businesses

--Managing Tax Remittance Cycles, and

--Following-up on Delinquent Accounts.

Ex. A

There are a number of recommendations in the report falling under these three categories. I would like to briefly take you through some of the more significant recommendations particularly those which may require legislative changes. I'll attempt to explain our recommendations and indicate the basis on which we made them.

Regarding the identification and registration of businesses, we recommended that the departments of Revenue and Human Resources execute an agreement to share records for the purpose of identifying businesses required to register to file taxes, but who fail to do so. This recommendation was based on a computerized test, matching sales and withholding taxpayer lists against a list of those remitting unemployment contributions to the Department of Human Resources. We found that there may be as many as 1,100 firms not remitting withholding tax to the State. As a result, we recommended that the two agencies agree to share taxpayer information so that a similar check could be done periodically in the future.

However, before such an agreement can be executed, K.S.A. 74-2424 will need to be amended to allow the Department of Revenue to share sales

and withholding taxpayer information with the Department of Human Resources. Therefore we recommend that the law be amended at this time.

In the second area we reviewed--managing tax remittances--we recommended the speeding up of withholding tax collections which has already been addressed by the Legislature during this session. We also recommended that the Department make a conscious effort to periodically review the filing status of sales tax accounts to determine if businesses should be filing monthly, annually, or quarterly. This recommendation was based on our finding that nearly one in every five sales tax returns filed in fiscal year 1981 appeared to be unnecessary. In all, more than 133,000 unnecessary returns were filed in 1981. Although some additional money was earned from interest on the more frequent payment of these taxes, it was about $70,000 less than the estimated handling costs.

We also found that about three percent of all sales tax accounts active for the entire year did not file returns as frequently as the law requires. In these cases, penalties and interest need to be assessed by the Department for non-compliance with the law.

The third area we reviewed dealt with the processing of delinquent accounts and is covered in Chapter three of the report. The report itself and the items I will cover in the remainder of the presentation generally follow the order of the tax collection cycle depicted on the diagram handed out to you earlier.

The first recommendation for processing delinquent accounts deals with identifying who is delinquent. We found that the department, for administrative reasons, granted a grace period for filing sales and withholding returns equal to five working days after the statutory deadline. As a result of large number of returns that are technically delinquent are processed as timely. Because we could find no statutory authority for the granting of blanket extensions for filing returns, we recommended that the Department stop allowing grace periods and enforce the deadline described in the statutes.

The Department has disagreed with this recommendation, stating that strict adherence to the statutory filing deadlines would require an examination of postmarks, thereby delaying the processing of returns.

If the legislature agrees that strict adherence to statutory deadlines places too great a burden on the Department, two alternatives appear to

exist. The first alternative is statutory authorization of grace periods for filing returns. The second alternative is to place the responsibility on the taxpayer by amending the law so that returns must be received by the Department by a specified date in order to be timely.

Another audit finding regarding filing deadlines relates to interest charges for retailers who have received an approved extension for filing returns. An administrative regulation which became effective May 1, 1979 stated that all retailers with approved extensions for filing returns later than the specified due date, must post a bond and pay interest on the amount of tax owed during the extended filing period. We found that the Department did not enforce this regulation until July 1981, more than two years after it became effective. The resulting loss ot the State was over $123,000. Therefore we recommended more timely enforcement of such regulations.

Regarding penalties on delinquent withholding accounts, we found that the Department did not appear to be in compliance with the provisions of K.S.A. 1981 Supp. 79-3228. This law requires the Director to estimate the tax due and to add a penalty of 50 percent when a taxpayer has failed to file a correct return within 20 days after notice from the Director of Taxation. We found that for the cases we sampled, the average time span

between the notice and the application of the penalty was four months rather than the specified 20 days. The Department has disagreed with this recommendation, stating that a first notice of delinquency does not trigger the 20-day period. The legislature may want to review this statute to determine if there needs to be clearer definition of what constitutes notice to the taxpayer.

Another recommendation, with which the Department agreed, is that there should be a minimum penalty established for delinquent returns. In many cases, businesses are delinquent in filing returns requiring no tax to be paid. Because current laws base the penalty on the amount of tax owed, these businesses suffer no penalty at all, even though the State may go to considerable expense to obtain the return. A minimum penalty would help the State to recoup collection costs and serve as an incentive for a firm to file its returns on time even if no tax is owed. It would also serve as an incentive for businesses to close out their accounts after they have ceased operations rather than to keep filing returns indefinitely.

We found no particular problems with the next couple of steps in the collection process. The processing of first and second notices to delinquent taxpayers was carried out on schedule as called for in Department

procedures. Only about 14 percent of the delinquent Sales Tax Accounts and 12 percent of the delinquent Withholding Tax Accounts we sampled required any collection efforts beyond a second notice.

The remaining recommendations primarily affect those 12 to 14 percent of delinquent accounts which we refer to as problem accounts. Referring back to your handout, the collection processes we will be talking about are primarily the last four boxes in the cycle diagram, jeopardy assessments and tax warrants, revocation hearings, injunctions, and bond seizures.

The first recommendations in this section deal with jeopardy assessments. For those of you who may not be familiar with a jeopardy assessment--it is a procedure used when a taxpayer fails to file returns and the Department determines that the collection of the tax may be in danger. In these cases, the Department can estimate the tax owed based on information available to them, and file a tax warrant creating a lien on the taxpayer's property for the amount of the assessment.

Kansas statutes say that the director of taxation shall immediately make such an assessment whenever a taxpayer commits an act which tends

to jeopardize the collection of the tax. Kansas administrative regulations further state that the director will consider the tax to be in jeopardy "whenever a taxpayer fails to file returns after written notice and either continues making retail sales or ceases operations. Using this criteria we reviewed the jeopardy assessments that were issued on the sales tax cases we sampled. A strict interpretation of the statutes and administrative regulations would require a jeopardy assessment at 45 to 61 days after delinquency, given current delinquency notification procedures used by the Department. In the cases we reviewed, we found that jeopardy assessments were not made within that time period, but were accumulated over several filing periods. In eight out of 13 cases, the jeopardy assessments were made from nine to fifteen months after the tax was originally due. Six of those accounts were inactive at the time of the review and owed the State more than $11,000 in unremitted taxes. For these reasons, we recommended that the Department comply with the statutes and administrative regulations regarding jeopardy assessments.

The Department disagrees with making jeopardy assessments as the law and regulations appear to call for, because they believe that it would be physically impossible and because they believe that the current jeopardy assessment law contains several defects. We simply point out that the procedure is not currently being carried out as the law appears to call for

and if the Legislature finds the current law and regulations to be acceptable, the Department should enforce them.

We also recommended that the Department require the taxpayer to pay the amount of jeopardy assessments rather than abating them when a taxpayer finally files returns if no hearing has been requested. The law provides a 15-day period in which the taxpayer may come forth and request a hearing on the accuracy of a jeopardy assessment before it becomes final. The Department, however, abates the jeopardy assessment even though no hearing was requested and regardless of when the taxpayer finally pays the tax. It is our belief, that abating the jeopardy assessments for taxpayers who don't comply with the law provides no incentive for delinquent taxpayers to come forward and file their returns. However, in order to institute a stricter policy on jeopardy assessments, and to protect the taxpayer's rights, the department would need to improve its procedures for notification of jeopardy assessments. Such notification requirements should probably be specified by statute.

In our review of the use of tax warrants, we found that warrants for the collection of delinquent withholding accounts were also not issued in the time frame the statutes appear to call for. The law requires a warrant to be filed if withholding tax is not paid within 60 days of the date it is

due. In our review of 50 delinquent withholding accounts, 15 accounts were more than 60 days past due but only two of the fifteen had a record of a warrant filed. Four of the fifteen were more than 200 days past due and only one of those four had a warrant filed. For these reasons, we recommended that the Department comply with the law regarding the filing of warrants for delinquent withholding taxes.

The Department disagreed with this recommendation on the grounds that filing a warrant within 60 days would require them to eliminate the second notice procedure currently used. Again, our recommendation simply points out that the Department's current procedures are not fulfilling what current statutes appear to require.

Referring back to the tax collection cycle on the handout, businesses that don't remit sales taxes after a jeopardy assessment or a warrant are usually scheduled for a hearing to revoke their sales tax registration. When revocation occurs, it becomes illegal for the business to make sales.

We found three problems with this process. First, although the Department has some written revocation procedures, in some cases, these guidelines leave too much to the judgement of employees in deciding when a business should have a sales tax registration revoked.

Second, the Department does not actively pursue prosecutions of those who violate the law by continuing to make sales with a revoked sales tax registration.

Finally, we did note cases where the Department reinstated sales tax registrants before they had paid all penalties or interest due or before they had posted a required bond.

The report makes recommendations calling for clearer guidelines for revocations, more careful review of reinstatements, and cooperation with the Attorney General's Office in prosecuting violators.

The next course of action the Department may pursue if a business continues to operate without remitting the necessary sales or withholding taxes is to request an injunction to close a business. In reviewing the injunction process, we found delays in issuing injunctions for both sales and withholding taxes. For sales tax accounts, it appeared that the Department could speed up the process by reducing the average 114-day time period before an injunction petition is filed with the court.

For withholding accounts, we found a delay of one and one-half years in implementing the injunction process after it was authorized by the 1980 Legislature.

In order to provide quicker recourse when businesses continue to operate without remitting tax collections to the State, we recommended that:

> The Department of Revenue should reduce the time between referral of a case to its Legal Services Bureau and the issuance of a petition for injunction.
>
> In addition, the Department should initiate procedures in a more timely manner after legislation is passed.

The final step in the normal process for collecting delinquent taxes is to seize the taxpayer's bond after the business is closed. Our review of bonding practices at the Department revealed several weaknesses. Bonds are not required frequently enough when a taxpayer registers to remit sales taxes. When bonds are requested to secure payment of taxes they are often not updated to keep pace with the size of tax remittances or they are

requested after an account has already gone bad and as a result are never supplied. Therefore, when all other collection efforts have been exhausted and the Department attempts to seize the bond to collect the tax, there is often no bond or ony a small bond available to seize.

To illustrate this, we reviewed 30 sales tax cases where businesses were scheduled for an injunction to cease operations for non-payment of taxes. In 16 of those cases, the businesses were actually closed. In total, those 16 businesses owed about $33,000 in taxes. However, only six of the 16 had any bond at all. Even in those six cases most of the bonds posted were not adequate to cover the full liability. As a result, most of the amount due was not able to be collected when the business was closed down.

The Department may argue that warrants were filed to cover the liability in each of these cases and that therefore, the money is protected. We maintain, however, that warrants are not a very effective means of collecting the tax. This can be demonstrated by the fact that almost $13 million dollars in sales and withholding tax warrants have been filed over the last five years, but only about $3 million was collected from warrants during the same period.

Because warrants provide at best, much delayed collection of the tax, we recommended that the Department strengthen its bonding policy to include bonds for all new businesses until a satisfactory payment record could be established, additional bonds for "high risk" accounts, and a periodic review of the adequacy of the bonds posted.

The Legislature should be aware that if such a policy is to be enacted, K.S.A. 1981 Supp. 79-3294(b) would have to be amended to allow the Department to obtain bonds at the time of registration from businesses remitting withholding tax. Current law permits a bond only after withholding accounts have been delinquent more than one reporting period. The Sales Tax Laws have no such restrictions.

DEPARTMENT OF REVENUE
SALES AND WITHHOLDING TAX COLLECTION PROCESS

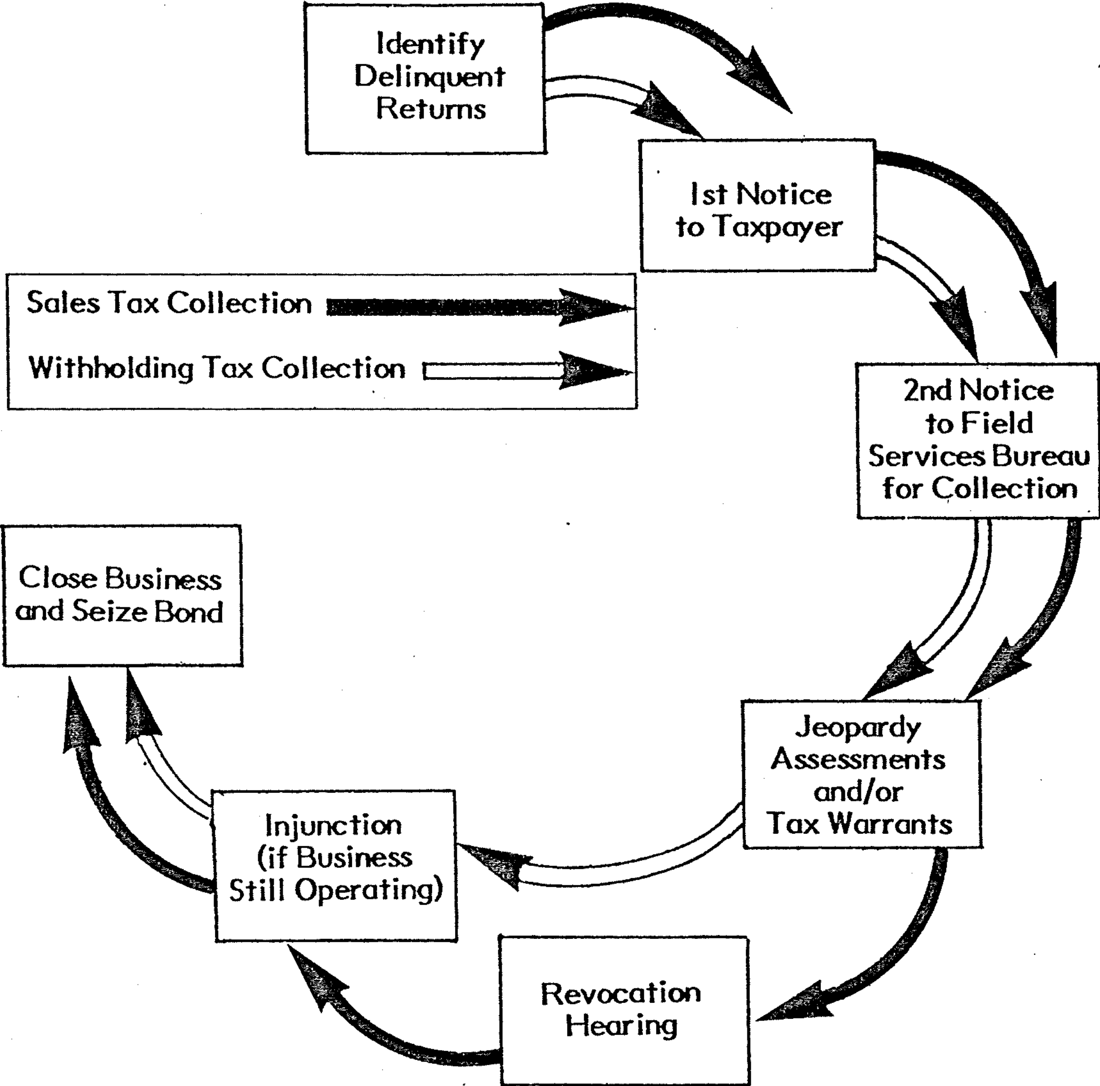

EXHIBIT B

STATEMENT

By

MARK BESHEARS

Director of Taxation

To

GOVERNMENTAL ORGANIZATION COMMITTEE

February 2, 1983

Ex. B

CHAIRMAN, MEMBERS OF THE COMMITTEE:

Thank you for the opportunity to appear this morning to comment on the Sunset Audit of the Division of Taxation of the Department of Revenue.

At the outset we would compliment the Post Audit staff for the courteous manner in which the audit was conducted. We would also acknowledge that certain of the recommendations contained in the report are sound and will be implemented as time and resources permit.

We would offer the general observation that virtually all procedures and practices of the Department which are the subject of Post Audit concern have been in effect for a number of years. We are also compelled to point out that initiatives undertaken by the Department to enhance deposit and collection efforts data clearly suggesting increased levels of enforcement activity and the K-BITS project, which is a comprehensive multi-year effort to improve the Department's ability to manage an integrated business tax system, were not included in the report for reasons not clear to the Department.

As is clear from our response to the draft report, however, the Department strongly disagrees with other aspects of the Post Audit Division's findings.

The Department takes strong exception to any suggestion that current or past administrative procedures relating to application of penalties and issuance of warrants are in any way contrary to Kansas law.

It was and remains the Department's position that a number of recommendations and conclusions contained in the report are based upon erroneous or misleadingly presentation of facts.

Examples of selective or erroneous presentation of data follow:

1. In suggesting a postmark method of determining delinquency status the Post Audit Division in its draft report failed to note the absence of postmarks on literally tens of thousands of envelopes.

In the final report, the Post Audit Division admits that 6.7 percent of the sample had unreadable postmarks but still does not appear to acknowledge that 6.8 percent or some 60,000 sales and withholding tax returns have no postmark at all. Moreover, no recommendation for handling returns contained in such envelopes appears in the report.

2. In calculating the number of allegedly delinquent returns received prior to the June cut-off date, the Post Audit Division made an error. As should have been noted, May 31, 1982 was Memorial Day. Because the last day of the month was a holiday, under both Kansas and Federal law, the filing deadline is extended by one day to June 1, 1982. All returns postmarked June 1, 1982, and some returns deposited late in the day on June 1, but postmarked June 2, would have been timely filed. The Post Audit Division overlooked this obvious and important item and, instead counted all returns postmarked June 1 as delinquent. As a result its statistical report of delinquent returns received prior to the cut-off date and its calculation of foregone interest earnings to the state are in error.
3. The draft report failed to note that the number of sales tax injunctions prepared increased from 98 in FY 1978 to 300 in FY 1982.
4. The draft report failed to note that the number of sales tax cash bonds required increased from 378 in FY 1978 to 944 in FY 1982.
5. The draft report failed to note that the number of sales tax revocation hearings increased from 1,398 in FY 1978 to 1,553 in FY 1982, with no increase in personnel.

6. The draft report failed to note that all sales tax assessments increased from $812,103 in FY 1978 to $8,623,887 in FY 1982.
7. The draft report failed to note that liquidated sales and withholding tax accounts receivable are cumulative for a period of 7 years and represent only 3/10th of one percent of the $4.04 billion in collections from those tax sources for that period.
8. We would also reference the Committee to Appendix A of the Department's response for a number of examples of the Post Auditor's use of specific case files which purport to show lax enforcement practices. The Department's response showed that the report contained various inaccuracies and misstatements with regard to the handling of these cases. It would appear also that these cases were selected because they are atypical and not because they are representative examples.
9. On page 53 of the Post Audit Report and again on page 86 of Appendix C it is indicated that "the State lost nearly $30,000 because no bond or an inadequate bond was obtained from 16 businesses which closed." An examination by the Department of these 16 accounts shows that in every situation the State is either covered by an adequate bond or a warrant has been filed covering the full liability.
10. The Post Audit Report failed to note that the Department, during December 1981 initiated a program to identify all withholding accounts that have "no tax" liability for six (6) consecutive quarters and no balance due. Letters were sent to approximately 3,350 of the "no tax" employers explaining to them that in order to save the cost of preparing and mailing quarterly reports (K-5) and the Department the cost

of processing these blank returns, their registration was going to be cancelled unless they expressly requested otherwise. The program outlined above has reduced the number of returns that need to be processed by approximately 3,100 per quarter.

The Department's use of administrative cut-off date for determining delinquent filing status is a major criticism contained in the report.

Initially, it should be pointed out that this procedure has been departmental policy through at least three administrations and has never before been questioned by the Post Audit Division.

There are sound reasons why the policy has been consistently followed in Kansas as it is in some 30 other states.

First, it would appear from sampling done by the Post Audit Division and the Department that of the 900,000 sales and withholding tax returns filed annually 15 percent or 135,000 would have an unreadable postmark or no postmark at all. Applying this percentage to all returns filed with the Department in FY 1981, approximately 375,000 envelopes would not have an identifiable postmark. How would the Post Auditor suggest the Department treat these returns? The only alternative would appear to be to establish an administrative cut-off date and make the presumption, as the Department currently does, that returns received prior to a cut-off date were timely filed. Additionally, how would the Post Auditor treat returns that were mailed late on the final day of the month but received a next-day postmark? These questions are raised to demonstrate that a postmark methodology for determining delinquent status is not as legally clearcut and certainly not as workable as the Post Audit Report suggests.

Second, reading postmarks, validating envelopes with returns and check, stamping postmark dates on returns and storing or microfilming envelopes would require a significant increase in personnel. To institute a postmark methodology in attempting

to determine when a taxpayer has filed a return with the Director of Taxation, the Department estimates a one-time cost of $150,000 and an annual cost of $120,000.

Third, recent experience in the State of Missouri provides insight regarding the difficulty and unproductivity associated with switching from an administrative cut-off methodology to a postmark methodology. The Missouri Department of Revenue reports that the filing pattern of taxpayers has not changed since adopting a postmark methodology. Further, the difficulties associated with reading postmarks - when available - has significantly delayed processing in that agency. The Director of Taxation for the State of Missouri is on record recommending a return to the use of an administrative cut-off procedure.

Fourth, use of a cut-off date is a reasonable exercise of administrative discretion, does not violate Kansas law, nor does it constitute a blanket filing deadline extension as suggested in the report. Rather, use of the cut-off date is merely an administrative method for determining when a return is made. The Department would submit that it is more equitable and more accurate than the postmark method for determining timely filing status.

Insofar as the Department has been able to determine such discretion has been exercised for at least 25 years and perhaps since the passage of the sales tax act in 1937.

Perhaps the Post Auditor believes that because the Internal Revenue Service uses postmarks to determine timeliness, such a criterion is inherent in Kansas law as well. We would point out that "timely mailing is timely filing" only by virtue of Section 7502 of the Internal Revenue Code. Federal case law places the burden on the taxpayer to prove timeliness in the absence of a readable postmark. In many cases this would require the taxpayer to obtain some form of proof of mailing such as a certificate of mailing which would be a heavy and expensive burden on the taxpayer. No similar statute is found in Kansas law.

A second issue of concern to the Post Auditor is the Department's timeliness in assessing 50% penalties for late withholding tax filings.

The Post Auditor concludes that the Department of Revenue has been violating the provisions of K.S.A. 1981 Supp. 79-3228(c) by not assessing a fifty percent penalty when a taxpayer fails to file a return within 20 days of the first notice from the Director.

The Post Auditor's interpretation of this provision is erroneous. Such an interpretation would require the Director of Taxation to impose a penalty generally equated with fraud to a return which was late as few as 35 days. We do not concur with this interpretation and believe it to be inconsistent with any other law administered by this State.

The Post Auditor reads into the statute the requirement that the 50% penalty be assessed after any notice from the Director. However, there is no requirement that the Director give any notice at all. We assume that the Post Auditor would find the Director of Taxation to be in compliance with the statute if he <u>never</u> mailed any notice and <u>never</u> assessed the fifty percent penalty. The Post Auditor agreed that the Director has complete discretion with respect to whether or when to send the notice which triggers the 50% penalty. The error is in assuming that <u>any</u> notice is intended to be the catalyst. Would the Post Auditor agree with the policy of issuing a notice after a one-day delinquency so the State could impose a 50% penalty in 21 days?

The quote from the case cited on page 92 in the Post Auditor's Report is taken out of context and is not on point. We would refer the Committee to <u>State v. Nelson</u>, 200 Kan. 411, in which the Supreme Court construed a requirement to sentence a defendant within 5 days as meaning "within a reasonable time." If the legislature believes that the Post Auditor's interpretation of 79-3228(c) truly represents legislative intent, a simple amendment could be made to codify such intent. Such amendment could require the Director to issue a notice of delinquency 15 days after the due date of the return

and further provide that failure to file within 20 days of that notice requires the addition of a fifty percent penalty. We believe the legislature would reject such an amendment.

A third concern of the Post Auditor was the question of when warrants should be issued for late filing of withholding tax returns.

The Post Auditor alleges that the Department of Revenue is not issuing warrants for nonpayment of withholding within 60 days of the due date as the Post Auditor contends is required by K.S.A. 79-3235. Again, we disagree with the Post Auditor's interpretation of the law. The relevant provision of K.S.A. 79-3235 merely provides the authority to issue the warrant and has not been disregarded by the Department of Revenue. Adopting the Post Auditor's recommendation would require the elimination of a procedure which, by the Post Auditor's own calculations, results in a success rate of approximately 88%. The success rate on warrants is less than 25% and all costs incurred in the filing of warrants against the vast majority of the taxpayers who pay the tax after field contact would be borne by the State. To short-circuit a procedure that works, for one that has been characterized by the Post Auditor as ineffectual, seems unreasonable.

Other areas of disagreement between the Department and the Post Audit Division are identified and more fully explained in the Department's response to the draft report.

It is our belief that recommendations and conclusions contained in the report do not have the strong conceptual foundation nor analytical incisiveness that have characterized prior audits of the Department. For that reason the Department does not concur with a number of recommendations suggested by the Post Auditor.